IT 03-5
Tax Type: Income Tax
Issue: Inclusion of Capital Gains and Base Income

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	No. 00-IT-0000 FEIN 00-0000000
v.	TYE 6/30/92 6/30/93 6/30/94
"PONDEROSA FOODS, INC.",	**Ted Sherrod**
Taxpayer	**Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Messrs. Ron Forman and Sean Cullinan, Special Assistant Attorneys General on behalf of the Illinois Department of Revenue; Messrs. Brian Browdy and Fred Marcus, of Horwood, Marcus & Berk on behalf of "Ponderosa Foods, Inc."

Synopsis:

The Illinois Department of Revenue ("Department") issued a Notice of Deficiency ("NOD") to "Ponderosa Foods, Inc." (hereinafter "Ponderosa" or "taxpayer"), for the tax years ending 6/30/92, 6/30/93 and 6/30/94. "Ponderosa" protested this NOD and requested a hearing. Pursuant to a pre-hearing order, the parties identified as the sole issue to be resolved at hearing whether tax was properly assessed on the gain produced by "Ponderosa's" sale of its stock in "A.B.B.A" a Swedish corporation, during the tax year ending 6/30/93.

The parties have filed a joint stipulation of facts, exhibits and memoranda of law in support of their respective positions. In their memoranda of law, the parties have addressed the following issues: 1) whether the taxpayer's gain from its sale of its minority interest in "A.B.B.A." in 1993 was business income under 35 **ILCS** 5/1501(a)(1) (hereinafter the "Business Income Issue"); and 2) whether the taxpayer's gain from this sale was taxable by Illinois or otherwise in violation of the Due Process and Commerce Clauses of the U.S. Constitution (hereinafter the "Due Process and Commerce Clause Issue").

A hearing on this matter was held on May 10, 2002. "Liam Udwin", the former President of "Ponderosa's" international group, and "Chip Kirkpatrick", "Ponderosa's" former Vice President and Controller testified at the hearing. After a review of the record herein, it is my recommendation that this matter be resolved in favor of the taxpayer.

Findings of Fact:

1. The Department's prima facie case, inclusive of all jurisdictional elements, was established by the admission into evidence of the Notice of Deficiency dated March 20, 2000. Stip. Ex. 26.[1]

2. "Ponderosa" is a corporation incorporated under the laws of Delaware, doing business worldwide, including in Illinois, with its headquarters located at "Someplace", Missouri. Stip. Ex. 25 (hereinafter "Stip. of Facts") ¶ ¶ 1, 2, 3; Stip. Ex. 23.

3. "Ponderosa" is a worldwide manufacturer and distributor of food products, and is engaged in the business of manufacturing, processing and distributing a wide variety of well-known food product brands. Until June 30, 1992, taxpayer operated over twenty

[1] Unless otherwise noted, findings of fact apply to the tax periods in controversy.

food plants in the United States. At the end of January, 1993, the taxpayer had 20 U.S. food plants; taxpayer also had manufacturing facilities in Canada, Europe, Australia and Venezuela. Stip. of Facts ¶ 2; Stip. Ex. 21, 22, 23.

4. "Liam Udwin" was the president of "Ponderosa's" international group from 1981 until his retirement in 1989. Tr. p. 22; Stip. Ex. 16.

5. "Chip Kirkpatrick" was the Vice President and Comptroller of "Ponderosa" from 1984 until 1996. Tr. pp. 151, 152; Stip. Ex. 16.

6. "Linda Stevens" was export manager of "Ponderosa" from 1989 until 1995. Stip. Ex. 24, Deposition of "Linda Stevens" (hereinafter "Dep. of "LS") pp. 6, 7.

7. Until July, 1992, the taxpayer's businesses were organized into the following three operating groups: i) the grocery group, engaged in the manufacture and distribution of "Ponderosa's" "Margaritaville" brand and other Mexican foods, Italian foods, frozen breakfast products, flavor enhancers, baked beans and seasoning mixes in the United States; ii) the frozen and specialty group, engaged in the manufacture and distribution of frozen fish products, frozen waffles and breakfast products, frozen pie crust shells, pies and cobblers, frozen dessert toppings, "Margaritaville" frozen products and refrigerated salads, specialty foods and entrees; and iii) the international group engaged in the manufacture and distribution of Italian foods, Chinese foods, "Margaritaville" and other Mexican foods, meats, meat spreads, snack foods and other food products. Tr. p. 90; Stip. Ex. 21, 23.

8. Effective July 1, 1992, the taxpayer realigned the company's businesses into the following groups: i) Worldwide Mexican Foods and International Group, engaged in the manufacture and distribution of "Margaritaville" and other Mexican foods in the United

States and worldwide, Italian foods in Canada, and national brands in the United Kingdom, Scandinavia, Australia and Venezuela; ii) Grocery Group, engaged in the manufacture and distribution of ready to serve soups and Italian foods, flavor enhancers, canned meat spreads, baked beans, oils, natural foods and "Ponderosa" evaporated milk; and iii) Frozen and Specialty Group, engaged in the manufacture and distribution of frozen food products including frozen seafood, frozen waffles and breakfast foods, frozen pie crusts, cream pies and cobblers, refrigerated salads and bakery products. As a result of this realignment, "Ponderosa's" "Margaritaville" manufacturing and distribution operations became a part of the taxpayer's international group. Stip. Ex. 23.

9. On May 26, 1993, "Ponderosa" was reorganized into five principal operating units as follows: i) Mexican Foods, including "Margaritaville" and other Mexican foods for distribution in the U.S.; ii) "Pasta Fazoo", including pasta, soups and Italian specialty foods; iii) Frozen Foods, including frozen seafood, frozen waffles and breakfast foods, and frozen pie crusts, cream pies and cobblers; iv) "Ubiquitous" Brands, including meat spreads, baked beans, flavor enhancers, evaporated milk and bakery products; and v) International, including "Margaritaville" outside of the United States, Italian foods in Canada, meat spreads in the United Kingdom and Australia, and deviled ham in Venezuela. Stip. Ex. 3, 22.

10. "Ponderosa" manufactures the "Margaritaville" brand of products at various locations in the United States outside of Illinois, and distributes the "Margaritaville" brand in Illinois and throughout the United States. "Margaritaville" products are manufactured domestically in "Someplace", Texas and "Someplace", Missouri. "Ponderosa" does not manufacture any "Margaritaville" brand products or any

ingredients used in these products in Illinois. Tr. pp. 90, 91, 99; Stip. of Facts ¶ 3; Stip. Ex. 23.

11. "Margaritaville" brand trademarks and trade names are held by "Ponderosa" and are managed in "Someplace", Missouri. Previously they were managed in "Someplace", Texas. Tr. pp. 91, 92.

12. "Okeechobi Food Co., Inc.", a "Ponderosa" subsidiary, operates a refrigerated salad plant in Illinois. "Ponderosa's" "Restaurant" unit, which makes sales to restaurants, blends spices in Illinois, and is a "Ponderosa" subsidiary, produces its "Allspice" line of spices in this state. Tr. pp. 92, 93, 94; Stip. of Facts ¶ 4; Stip. Ex. 23.

13. In 1965, "Ponderosa" and "FMS AB", an unrelated Swedish corporation based in "Someplace", Sweden, formed a joint venture, "A.B.B.A." as a corporation incorporated under the laws of Sweden, to manufacture and market a line of salty snack foods for the Scandanavian market. At "A.B.B.A's" inception, "Ponderosa" and "FMS AB" each contributed $350,000 to capitalize "A.B.B.A.", and owned 50 percent of "A.B.B.A's" stock. Tr. pp. 28, 29, 30, 53, 54, 95, 153, 154; Stip. of Facts ¶ ¶ 5,6; Stip. Ex. 17.

14. The joint venture agreement creating "A.B.B.A." was entered into by "Ponderosa" and "FMS AB" on May 25, 1965. This agreement delineated rights of first refusal, voting requirements for Board approval and termination rights. Pursuant to this agreement, "Ponderosa" had the power to veto any action by "A.B.B.A.'s" Board, but never exercised this veto power. Tr. pp. 96, 97; Stip. Ex. 6, 8.

15. Subsequent to its formation, "A.B.B.A." developed a line of snack foods marketed under the "A.B.B.A." brand name. These products included popcorn, potato chips and other similar snack foods. Tr. pp. 95, 153, 159; Stip. Ex. 23.

16. "Lip Smackin'", a company engaged in the production of snack foods with "Ponderosa" in the U.S. at the time "A.B.B.A." was formed, assisted "A.B.B.A." in developing snack foods from its inception in 1965 until 1966 or 1967. Tr. pp. 29, 30.

17. At the request of its joint venture partner, "FMS AB", "Ponderosa" sold 1 percent of its stock in "A.B.B.A." to "FMS AB", which was transferred to "FMS AB" in 1981. This transfer was undertaken pursuant to "FMS AB's" representation that Swedish law required it to permit consolidation of "A.B.B.A." into "FMS AB's" profit and loss statements. After this sale, "Ponderosa" owned 49 percent of "A.B.B.A.'s" stock. However, pursuant to a management agreement with "FMS AB", "Ponderosa" maintained control of 50 percent of the seats on "A.B.B.A.'s" Board of Directors. Tr. pp.154, 155, 156; Stip. of Facts ¶ ¶ 8, 9; Stip. Ex. 6, 17.

18. Subsequent to its sale of its one percent interest in "A.B.B.A." in 1992, "Ponderosa" accounted for its 49 percent interest using the equity method of accounting. Pursuant to the equity method, "Ponderosa" recorded 49 percent of "A.B.B.A.'s" net income as "Ponderosa" net income on "Ponderosa's" financial statements. "Ponderosa's" decision to account for its interest in "A.B.B.A." in this manner was approved by its independent auditor. Tr. pp. 159, 160, 161, 162, 181, 182; Stip. of Facts ¶ 17; Stip. Ex. 21, 22.

19. "Ponderosa" had three seats on "A.B.B.A.'s" Board from the inception of "A.B.B.A." until this company was sold in 1993. "Liam Udwin", the president of "Ponderosa's" international group, served as a member of "A.B.B.A.'s" Board of Directors, and the Chairman of "Ponderosa's" Board. "Jack Sprat", Chairman of the Board of "Sprat's Inernational", a "Ponderosa" subsidiary, served on the Board after

"Ponderosa's" Chairman withdrew. "Liam Udwin" had the right to vote on behalf of all of "Ponderosa's" directors and his positions reflected "Ponderosa's" corporate positions on board matters. Tr. pp. 26, 27, 28, 55, 56, 57, 71, 74.

20. "Ponderosa" had no authority over the day to day operations, procedures and policies of "A.B.B.A.". Tr. p. 97.

21. "Ponderosa" did not mange "A.B.B.A." and was not involved in the day to day management or decision-making processes of "A.B.B.A.". Tr. pp. 97, 98, 104, 105, 157.

22. No "A.B.B.A." officer was an officer of "Ponderosa". No "A.B.B.A." officer or director sat on "Ponderosa's" Board and no "A.B.B.A." officer or director was an officer or director of any "Ponderosa" subsidiary. Tr. pp. 95, 96.

23. "FMS AB" had no seats on "Ponderosa's" Board. No "FMS AB" officers served as officers of "Ponderosa" and no "FMS AB" officers or directors served as officers or directors of any "Ponderosa" subsidiary. Tr. p. 96.

24. "Ponderosa" received dividends from "A.B.B.A." after 1989; these dividends were minor and were not required to finance "Ponderosa's" operations. Tr. pp. 169, 170.

25. "A.B.B.A.'s" growth, including its sale of "A.B.B.A." brands, fit "Ponderosa's" plans for growth of its sales in international markets. Tr. pp. 57, 58, 59, 60, 61, 62, 63, 64, 65, 66.

26. "Ponderosa" encouraged "A.B.B.A." to expand into new Scandanavian markets. Tr. pp. 47, 58, 112, 113.

27. "A.B.B.A." provided "Ponderosa" with a monthly balance sheet and profit and loss statement for every month except January and July, and a statement showing the number of units of "A.B.B.A." and "Margaritaville" products sold by "A.B.B.A." during

each monthly period for which reports were prepared. These reports were primarily used to determine "Ponderosa's" pro rata share of "A.B.B.A.'s" earnings, which were included in "Ponderosa's" book income. Tr. pp. 158, 159, 164, 165; Stip. Ex. 4.

28. In 1982, "A.B.B.A." became a distributor of "Ponderosa's" "Margaritaville" brand products in Sweden. All of the "Margaritaville" products purchased by "A.B.B.A." from "Ponderosa" pursuant to this agreement were manufactured exclusively for "Ponderosa" at its facilities in Texas and at the facilities of "Margaritaville RS", a "Ponderosa" affiliate based in the Netherlands. Some ingredients of "Margaritaville" products distributed by "A.B.B.A." were produced in England and Montreal. Tr. p. 99; Stip. of Facts ¶ 10; Dep. of "LS" pp. 25, 26, 31, 32.

29. "A.B.B.A." asked to become a "Ponderosa" distributor. Tr. p. 50.

30. "Ponderosa" products were also distributed by "Ponderosa" subsidiaries and independent distributors. "Ponderosa" distributors purchased products made in the United States from "Ponderosa", warehoused them, and marketed them to retail stores. Prices charged subsidiaries and non-affiliated distributors were computed in the same manner as prices charged "A.B.B.A." for "Margaritaville" products. Tr. pp. 44, 45, 109, 110; Stip. of Facts ¶ 19; Stip. Ex. 17.

31. "Ponderosa" sold its "Margaritaville" products to "A.B.B.A." at a discount based upon "A.B.B.A.'s" use of proceeds from its sales of "Margaritaville" products to develop this brand in Sweden and Scandinavia, and on "A.B.B.A.'s" distribution costs. This was the same formula "Ponderosa" used in determining prices it charged other distributors of "Margaritaville" products. Tr. pp. 108, 109, 110; Stip. Ex. 17.

32. "A.B.B.A." was not licensed or authorized to manufacture "Margaritaville" products and did not manufacture any of these products. Tr. pp. 99, 100.

33. "Ponderosa" provided packaging and packaging specifications regarding "Margaritaville" products to "A.B.B.A." and to subsidiaries and non-affiliated distributors. Dep. of "LS" pp. 40, 41.

34. "Ponderosa" was responsible for training the workforce of "Margaritaville" distributors, and checked governmental regulations by country for ingredient and packaging requirements and advertising regulations pertaining to this brand of products. Dep. of "LS" p. 30.

35. "A.B.B.A." was selected to distribute "Ponderosa" products in Sweden because "A.B.B.A." had a warehousing and distribution system in place. Also because "Ponderosa" viewed "A.B.B.A." as better than anything else available in Sweden for distribution, sales and marketing, and because it had a sales force and distribution system that was well known in the local Swedish market. Tr. pp. 50, 101, 102; Dep. of "LS" p. 15.

36. "Ponderosa" products were distributed by independent distributors in Norway, Denmark and Finland. Other Swedish distributors were available to distribute "Ponderosa" products, and would have been selected if "Ponderosa" and "A.B.B.A." had terminated their distribution agreement. Tr. pp. 43, 48, 102.

37. "A.B.B.A." was "Ponderosa's" only vehicle for the distribution of "Margaritaville" products in Sweden. "Margaritaville" was the only "Ponderosa" brand "A.B.B.A." distributed. Tr. pp. 43, 47, 98; Stip. of Facts ¶ 10.

38. "Ponderosa" did not distribute any "A.B.B.A." products in the United States. Tr. p. 98.

39. There was no interchange of employees or personnel, marketing research or expertise, proprietary recipes or trade secrets between "Ponderosa" and "A.B.B.A.". Tr. pp. 106, 107, 108.

40. Unlike "Ponderosa's" wholly owned subsidiaries, "A.B.B.A." did not have access to "Ponderosa's" proprietary recipes or trade secrets and its knowledge of this information was limited to what was listed on cartons and packages. Tr. pp. 104, 105, 106.

41. "Ponderosa" did not manage "A.B.B.A." and was not involved in the day to day management or decision-making processes of "A.B.B.A.". Tr. pp. 97, 98, 104, 105, 157.

42. By agreement between "FMS AB" and "Ponderosa", no action could be taken by "A.B.B.A.'s" Board of Directors without "Ponderosa's" approval or acquiescence. Tr. pp. 72, 96, 97.

43. "A.B.B.A.'s" management made all decisions regarding the purchase and distribution of "Margaritaville" products, including what quantity of "Margaritaville" products to purchase from "Ponderosa", and which "Margaritaville" products "A.B.B.A." would distribute. "Ponderosa" delegated this responsibility to "A.B.B.A." because "Ponderosa" had no intricate knowledge of Scandinavian markets and relied completely upon the local talent and marketing expertise of "A.B.B.A." and "FMS AB". Tr. pp. 100, 101.

44. "Ponderosa" audited "A.B.B.A.'s" books and coordinated "A.B.B.A.'s" financial reports with "Ponderosa's" reports. However, "Ponderosa" provided no other accounting

services to “A.B.B.A.”, and provided no public relations, medical, insurance, legal, tax, regulatory, billing or other non-accounting services to “A.B.B.A.”. Tr. p. 108.

45. “Ponderosa’s” law department provided services related to registering and protecting “Ponderosa’s” licenses and trademarks to “A.B.B.A.”. Dep. of “LS” pp. 53, 54, 55.

46. “Ponderosa” did not use its interest in “A.B.B.A.” as security for loans to meet “Ponderosa’s” capital needs, and no “A.B.B.A.” shares were ever pledged by “Ponderosa” as collateral for any loans. Tr. pp. 170, 171.

47. “A.B.B.A.’s” projected and actual sales were consolidated into “Ponderosa’s” sales for internal accounting purposes, but were not treated as “Ponderosa” sales in “Ponderosa’s” earnings reports and financial statements. All of “A.B.B.A.’s” sales were consolidated into “FMS AB’s” sales included in “FMS AB’s” financial reports. Tr. pp. 114, 115, 116, 117, 118, 119, 120, 158, 159, 160.

48. “A.B.B.A.’s” projected sales of “Margaritaville” products produced in the U.S. were included in the “Ponderosa” international group’s projected 12 month forecast used to plan production of “Margaritaville” products for international distribution. Dep. of “LS” pp. 50, 51, 52.

49. “A.B.B.A.’s” projected and actual sales were reported to “Ponderosa’s” management. “A.B.B.A.’s sales performance was considered by “Ponderosa’s” management when it determined whether the international group was meeting its sales growth performance objectives. Tr. pp. 67, 70, 118, 119, 120; Stip. Ex. 14.

50. "Ponderosa" conducted product development research for its "Margaritaville" brand in Illinois. "Ponderosa's" domestic and international brands both benefited from this research. Tr. pp. 139, 140, 141.

51. "A.B.B.A.'s" president reported to the chairman of the board of "FMS AB", and "FMS AB"'s president was responsible for directing "A.B.B.A.'s" president. Tr. pp. 68, 69.

52. Sales of "Margaritaville" Products constituted approximately 7% of "A.B.B.A.'s" total sales in March 1992 and approximately 11% of "A.B.B.A.'s" total sales in March 1993. Stip. Ex. 4.

53. "A.B.B.A.'s" average annual sales of "Margaritaville" products between 1990 and 1993 were approximately $9 million, while "Ponderosa's" average annual total sales were $2 billion. Stip. of Facts ¶ ¶ 14, 15.

54. "Ponderosa's" international group was formed in 1981 in order to make "Ponderosa" products available in European markets and to increase "Ponderosa's" annual sales; the international group is headquartered in "Someplace", Missouri. Tr. pp. 21, 22, 23, 31, 46, 134, 135.

55. At its inception, the international group established a goal to represent 25 percent of "Ponderosa's" total sales within 10 years of its formation. To achieve this goal, "Ponderosa" adopted a strategy to increase its presence in foreign markets by buying locally owned and controlled companies having demonstrated expertise in foreign marketing and distribution. Tr. pp. 24, 25, 32, 33, 38, 42.

56. "A.B.B.A." was an original component of "Ponderosa's" international group. Tr. pp. 30, 31.

57. "A.B.B.A." was included in "Ponderosa's" international group because it operated outside of the United States and therefore could not be included in "Ponderosa's" other groups, which were all related to "Ponderosa's" domestic operations. Tr. pp. 174, 175.

58. In order to effectuate its plans to increase "Ponderosa's" international market, in 1981 "Ponderosa" acquired "Wombat, Inc." and its subsidiaries in England, Australia, Venezuela, Mexico and Canada. "Ponderosa" also acquired "Wombat's" joint venture interest in a Costa Rican joint venture and "Topo Gigio", a Canadian manufacturer of Italian foods. These companies were autonomously managed, and "Ponderosa" was not involved in their day to day operations because of their superior expertise in marketing and distributing food products in foreign markets. "Liam Udwin" served on the boards of these companies. Tr. pp. 25, 26, 27, 28, 33, 34, 35, 36, 37, 129, 130, 131, 132, 166, 167.

59. "Ponderosa" sold its Costa Rican joint venture interest soon after acquiring it, in the early 1980s. Tr. pp. 111, 112.

60. The president or chairman of the board of all of the companies in "Ponderosa's" international group, except "A.B.B.A.", reported to the president of "Ponderosa's" international group. The president of "Ponderosa's" international group had to approve all capital expenditures by these companies. Tr. pp. 128, 131.

61. "Ponderosa" attempted to sell its 49 percent interest in "A.B.B.A." in 1987, but was prevented from doing so by "FMS AB". Tr. pp. 74, 75; Stip. Ex. 7.

62. In May, 1993, "Ponderosa" sold its remaining 49 percent interest in "A.B.B.A." to "FMS AB", recognizing a net capital gain of $80,852,894. The proceeds of this sale were used to reduce debt resulting from "Ponderosa's" spin-off from its parent in 1991.

"Ponderosa" reported this gain as non-business income on its 1993 Illinois income tax return. Tr. pp. 171, 172, 173; Stip. of Facts ¶ 18; Stip. Ex. 18, 20, 22.

63. The sale of "A.B.B.A." was part of an overall restructuring of "Ponderosa's" operations to divest businesses outside of the company's core businesses. Stip. Ex. 3, 22.

64. Subsequent to "Ponderosa's" sale of its entire interest in "A.B.B.A.", "A.B.B.A." continued to act as a "Ponderosa" distributor of "Margaritaville" products pursuant to the terms of an agreement entered into between these parties on May 26, 1993. The terms and conditions governing "A.B.B.A.'s" distribution of "Margaritaville" products were the same as the terms and conditions governing this activity prior to the sale of "A.B.B.A." by "Ponderosa". Stip. of Facts ¶ 19; Stip. Ex. 17.

65. "Ponderosa", "Wombat, Inc.", "Pasta Fazoo Company", "Helmut Food Co., Inc.", "Feranti & Teicher Co., Inc.", "Okeechobi Food Company, Inc.", "Margaritaville" Food Company, Inc., "STL Company", and "Ponderosa International, Inc." were included in "Ponderosa's" Illinois unitary business group reported on its Illinois income tax returns for 1992 and 1993. All of these companies except "Ponderosa International, Inc." were members of "Ponderosa's" unitary business group in 1991. "Steubenville Co." was also a member of this group in 1991. Stip. Ex. 19, 20.

66. "Margaritaville", Inc. is a subsidiary of "Ponderosa" based in "Someplace", Missouri. This company has no property, payroll or sales in Illinois and is not required to file an Illinois income tax return. Stip. of Facts ¶ 13; Stip. Ex. 19, 20.

Conclusions of Law:

Business Income Issue

The issue to be determined is whether the capital gain realized by the taxpayer when it sold 49% of the stock of "A.B.B.A." constituted business income apportionable to Illinois. The taxpayer contends that it properly reported this gain as non-business income on its state income tax return for the tax year ending June 30, 1993.

Section 1501(a)(1) of the Illinois Income Tax Act ("IITA"), 35 **ILCS** 5/1501(a)(1), (hereinafter "section 1501(a)(1)") defines "business income" as being "income arising from transactions and activity in the regular course of the taxpayer's trade of business … and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade of business operations." Section 1501(a)(13) of the IITA, 35 **ILCS** 5/1501(a)(13), defines "non-business income" as being "all income other than business income or compensation."

A taxpayer's income is business income unless it is clearly non-business income. 86 Ill. Admin. Code § 100.3010(a). Pursuant to section 904 of the IITA, 35 **ILCS** 5/904, the Department established the *prima facie* correctness of its determination that the items of income were business income when it introduced the NOD for 1993 into evidence at the hearing. Stip. Ex. 26.

Burden of Proof

The burden of proof is on the taxpayer to prove that the income in question is non-business income. Kroger Company v. Department of Revenue, 284 Ill. App. 3d 473, 479 (1st Dist. 1996). To carry its burden in a civil case, a party ordinarily need only

persuade the trier of fact that a "preponderance of the evidence" favors the taxpayer. Schwachman v. Greenbaum Mortgage Co., 115 Ill. App. 3d 234 (1st Dist. 1983); Spankroy v. Alesky, 45 Ill. App. 3d 432 (1st Dist. 1977) (citing 18 I.L.P. s 345 ["In a civil action, a party need only prove his case or an affirmative defense by a preponderance of the evidence, or, in other words, by the greater weight of the evidence"]). This means that the party with the burden of going forward must persuade the trier of fact that the proposition on which it has the burden is more probably true than not true. Reivitz v. Chicago Rapid Transit Co., 327 Ill. 207 (1927). However, the Department argues that to prevail in this case, the taxpayer must rebut the Department's prima facie case by presenting "clear and cogent" evidence that the taxpayer's income is not business income under section 1501(a)(1). Department Brief pp. 8, 9, 10. As noted in the Department's brief:

> The clear and convincing standard is considered to be more than a preponderance of the evidence, while not quite approaching beyond a reasonable doubt. Estate of Ragen v. Ragen, 79 Ill. App. 3d 8, 12, 34 Ill. Dec. 523, 527 (1st Dist. 1979). As a benchmark, "the preponderance of the evidence standard has been defined as evidence sufficient to incline an impartial reasonable mind to one side of an issue rather than the other." *Id*. Stated differently, "a proposition proved by a preponderance of the evidence is one that has been found to be more probably true than not." *Id*. A clearer way to think of the differences between the preponderance, clearer and convincing (cogent), and beyond a reasonable doubt burden of proofs, is to think of them, respectively, as probably true, highly probably true, and almost certainly true. *Id*, citing McBaine, Burden of Proof: Degrees of Belief, 32 Calif. Law Rev. 242 (1944).
> Dept. Brief pp. 9, 10

As noted by the Department, the "clear and cogent" evidence standard requires the presentation of more persuasive evidence than the "preponderance of the evidence" standard typically applied in civil cases. Consequently, a taxpayer presenting evidence

sufficient to establish non-taxability under the "preponderance of the evidence" standard would not prevail if such evidence was not "clear and cogent" or "clear and convincing" evidence of the taxpayer's claims.

In support of its "burden of proof" argument, the Department cites U.S. Supreme Court cases that have addressed the apportionment of income under state income tax statutes. Dept. Brief at p. 8, citing Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 164 (1983); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 793 (1992). These cases have indeed adopted the higher burden of proof standard the Department advocates. However, a review of these cases indicates that the Supreme Court has adopted this higher standard of proof only with respect to determinations regarding the constitutionality of state apportionment provisions. Container Corp. of America, *supra*; Allied-Signal, *supra*. See also Moorman Manufacturing Co. v. Bair, 437 U.S. 267, 274 (1978); Butler Brothers v. McColgan, 315 U.S. 501, 507 (1942); Exxon Corp. v. Department of Revenue, 447 U.S. 207, 221, 222 (1980). The Illinois appellate court in Hercules, Inc. v. Department of Revenue, 324 Ill. App. 3d 329 (1st Dist. 2001) also adopts this higher standard of proof, but only in determining whether the apportionment of income by Illinois in that case was constitutionally permitted. *Id* at 336.

The threshold issue in this case is whether the taxpayer's income is apportionable income under Illinois statutory law. The U.S. Supreme Court has never required a showing of "clear and cogent" or "clear and convincing" evidence in determining whether the taxpayer has overcome the Department's prima facie showing of taxable business income under Section 1501(a)(1). Moreover, the Illinois courts have repeatedly

stated that the taxpayer need only produce credible evidence corroborated by books and records to rebut the presumed correctness of the Department's findings. Balla v. Department of Revenue, 96 Ill. App. 3d 293 (1981); Jefferson Ice Co. v. Johnson, 139 Ill. App. 3d 626 (1985); Mel-Park Drugs v. Department of Revenue, 218 Ill. App. 3d 203 (1991); A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1988); Masini v. Department of Revenue, 60 Ill. App. 3d 11 (1978); Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1988); PPG Industries, Inc. v. Department of Revenue, 328 Ill. App. 3rd 16 (1st Dist. 2002).

In Texaco-Cities Service Pipeline Co. v. Department of Revenue, 182 Ill. 2d 262 (1998), the court states that "(a)n entity claiming that its income is non-business income bears the burden of clearly proving this fact." *Id* at 268. See also Automatic Data Processing, Inc. v. Department of Revenue, 313 Ill. App. 3d 433, 440 (1st Dist. 2000). However, even if one assumes that this assertion addresses the taxpayer's burden of proof, it is at best *obiter dictum* because there is no evidence that the court required a showing by "clear and cogent" or "clear and convincing" evidence to overcome the Department's prima facie case. Moreover, cases that require a showing of "clear and cogent" or "clear and convincing" evidence cited by the Department in its brief use these very terms to indicate the application of a higher burden of proof than a "preponderance of the evidence" standard. Dept. Brief p. 9, citing Kuska v. Vankat, 341 Ill. 358 (1930); Albers v. Smiler et al, 20 N.E. 2d 631, 633 (2nd Dist. 1939); In the Matter of Jones, 285 Ill. App. 3d 8, 13 (3d Dist. 1996); In The Interest of Jones, 34 Ill. App. 3d 603 (1st Dist. 1975); Estate of Ragen v. Ragen, 79 Ill. App. 3d 8 (1st Dist. 1979).[2] The language used

[2] The Department argues that the "clear and cogent" standard of proof is synonymous with the "clear and convincing" standard "defined under Illinois law as a quantum of proof which leaves no reasonable doubt

by the court in Texaco indicating that the taxpayer must "clearly" establish its claim, does not use the term "clear and cogent" evidence. Nor does it refer to the need for "clear and convincing" evidence, as do cases cited by the Department which apply a higher standard.

Furthermore, the burden of proof in administrative proceedings is governed by section 10-15 of the Illinois Administrative Procedures Act, 5 **ILCS** 100/10-15. This section provides as follows:

> Standard of Proof. Unless otherwise provided by law or stated in the agency's rules, the standard of proof in any contested case hearing conducted under this Act by an agency shall be the preponderance of the evidence.
> 5 **ILCS** 100/10-15[3]

Neither the Department's rules governing "Practice and Procedure for Hearings Before the Illinois Department of Revenue", 86 Ill. Admin. Code § 200.101 *et seq.*, nor any other Department of Revenue regulation modifies this statutorily prescribed standard in cases construing the meaning of "business income" under section 1501(a)(1). While regulation 86 Ill. Admin. Code § 100.3010 provides that a taxpayer's income is business income unless "clearly" non-business income, it does not address the burden of proof to be applied in determining whether income is "business" or "non-business" income in administrative hearings.

The Illinois courts have never equated a showing by "clear" evidence with the "clear and cogent" or "clear and convincing" burden of proof noted above, and the

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in the mind of the trier of fact as to the truth of the proposition in question." Dept. Brief p. 9. It cites Kuska v. Vankat, 341 Ill. 358, 362 (1930), and Albers v. Smiler et al, 20 N.E. 2d 631, 633 (2nd Dist. 1939) as examples of cases that use these terms interchangeably.

Department's regulations have used the same "burden of proof" terminology as the courts. See 86 Ill. Admin. Code § 100.3390 requiring proof "by clear and cogent evidence" that an alternative to the IITA's statutorily prescribed apportionment formula is permissible. For the foregoing reasons, I conclude that the burden of proof applicable in determining whether the taxpayer's income is business income under section 1501(a)(1) in this case is the "preponderance of the evidence" standard prescribed at 5 **ILCS** 100/10-15.

Application of the "Transactional" and "Functional" Tests under Section 1501(a)(1)

Section 1501(a)(1) provides for two tests to determine if income is business income. The tests are described as the transactional test and the functional test. If the income satisfies either test, it is business income. Dover Corporation v. Department of Revenue, 271 Ill. App. 3d 700, 711 (1st Dist. 1995). The transactional test, which is derived from the first clause of section 1501(a)(1), classifies income as business income if the income is derived from a type of transaction the taxpayer normally conducts in its enterprise.[4] The functional test is derived from the second clause of section 1501(a)(1), and classifies income as business income if the property disposed of constituted an integral part of the taxpayer's business operations.

The record indicates that the transactional test has not been satisfied in this case. The Department all but concedes this fact by only arguing that the gain is not business income under the functional test. Tr. pp. 7, 8; Dept. Brief p. 10 ("The functional test

[3] The Illinois Department or Revenue is an "agency" to which 5 **ILCS** 100/10-15 applies; see 5 **ILCS** 100/1-20.

[4] The Illinois Supreme Court has stated that an item of income is business income under the transactional test only if it is "attributable to a type of business transaction in which the taxpayer regularly engages". Texaco-Cities Service Pipeline Co. v. McGaw, 182 Ill. 2d 262, 269 (1998), quoting National Realty & Investment Co. v. Department of Revenue, 144 Ill. App. 3d 541, 554 (1986).

applies in this case"). Moreover, the documentary evidence fully supports the taxpayer's claim that the sale of its interest in "A.B.B.A." was not the type of transaction the taxpayer normally conducts in its business. There is no evidence in the record that "A.B.B.A." was in the regular business of buying, holding and selling the stock of other corporations. While the taxpayer made several dispositions of businesses in the year it sold its investment in "A.B.B.A.", these dispositions were the logical consequence of the taxpayer's decision to divest itself of activities unrelated to its core business. Stip. Ex. 2, 3, 22.

The record indicates that the taxpayer did not engage in sales of businesses with the systematic regularity characteristic of normal trade or business operations. Although "Ponderosa" sold three other businesses in 1993, the year it sold its investment in "A.B.B.A.", the taxpayer's 10-K indicates that "Ponderosa" engaged in only one similar transaction in the five years preceding these sales. Stip. Ex. 23. Accordingly, the record establishes that these sales were part of extraordinary transactions designed to refocus the taxpayer's operations, rather than routine or ordinary business activities.

The functional test, which the Department contends has been met in this case, is drawn from the second clause of section 1501(a)(1). Under the functional test, the relevant inquiry is whether the property was an integral component of the taxpayer's regular trade or business operations. See Section 1501(a)(1) identifying business income as "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations". (Emphasis supplied). The principal issue presented in this case involves the application of the functional test for determining business income.

The record shows that "Ponderosa" and "FMS AB" formed "A.B.B.A." in 1965 to manufacture and develop a line of snack foods for the Scandanavian market. Tr. pp. 28, 29, 30. When "A.B.B.A." was created, "Ponderosa's" food business included snack foods. Tr. pp. 29, 30. The record clearly establishes that at the time "A.B.B.A." was formed, "Ponderosa" intended to use its expertise in the snack food business to develop "A.B.B.A.'s" snack food operations in Sweden. Tr. pp. 29, 30. However, "Ponderosa" withdrew its technology and other resources from "A.B.B.A." in 1967, only one or two years after this company was formed. *Id*. Moreover, there is no evidence in the record that snack foods continued to be a part of "Ponderosa's" business. The record contains no evidence that any snack food business was conducted through "Ponderosa's" divisions and subsidiaries (hereinafter "Ponderosa's" "unitary business")[5] during the tax periods in controversy. Nor is there any mention of any snack food interest other than "Ponderosa's" joint venture interest in "A.B.B.A." in any of "Ponderosa's" annual reports contained in the record. Stip. Ex. 21, 22. After "Ponderosa's" withdrawal of its resources from "A.B.B.A.", "A.B.B.A." developed its own line of snack foods. Tr. pp. 30, 95, 153, 159. While "A.B.B.A." grew significantly after its formation (Tr. p. 54), the record does not indicate any contribution by "Ponderosa" to "A.B.B.A.'s" snack food business after 1966 or 1967.

After "Ponderosa" withdrew from active participation in "A.B.B.A.", "Ponderosa's" investment in the stock of "A.B.B.A." had nothing to do with "Ponderosa's" unitary business until "A.B.B.A." became a "Ponderosa" distributor in

[5] "Ponderosa" and many of its operating subsidiaries, including "Wombat, Inc.", the parent company of most of "Ponderosa's" international group of companies (Tr. pp. 26, 27, 28, 29), are identified as a unitary business group in "Ponderosa's" Illinois income tax returns. Stip. Ex. 19, 20.

1982. Had "Ponderosa" sold "A.B.B.A." during the interval between "Ponderosa's" withdrawal from "A.B.B.A." and "Ponderosa's" decision to make "A.B.B.A." a distributor in 1982, there is no question that the gain produced would have been non-business income because "A.B.B.A.'s" operations had nothing to do with "Ponderosa's" unitary business operations during this interval. Allied-Signal, at 772 ("A State may not tax a non-domiciliary corporation's income, however, if it is derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" [quoting Exxon Corp. v. Department of Revenue, 447 U.S. 207, 224 [1980]).

In 1981, "Ponderosa" formed its international group which included "A.B.B.A.". Tr. pp. 21, 22, 23, 30, 31; Stip. Ex. 16. In 1982, "Ponderosa" agreed to allow "A.B.B.A." to distribute "Ponderosa's" "Margaritaville" brand of products in Sweden. Stip.¶10. "A.B.B.A." became part of a network of "Ponderosa" distributors in Europe and other parts of the world. Tr. pp. 44, 45, 109, 110. This network consisted of both subsidiaries and non-affiliated companies. *Id*. Given "A.B.B.A.'s" status as a passive investment of "Ponderosa" from approximately 1967 until 1982, the issue presented here is whether "Ponderosa's" decision to utilize "A.B.B.A." as one of its distributors changed the nature of its relationship with "A.B.B.A." from that of a passive investor. To decide this issue, it must be determined whether "A.B.B.A." became an integral part of "Ponderosa's" operations after 1982.

After 1967, there is no evidence of any involvement of "Ponderosa" in the development, production or distribution of snack foods, which was the major business activity of "A.B.B.A.". Even after "Ponderosa" appointed "A.B.B.A." as its distributor, "A.B.B.A.'s" primary business continued to be the manufacture and distribution of its

own line of snack foods. The record suggests that from 80% to 90% of "A.B.B.A.'s" revenues were from the snack food business. Tr. p. 54; Stip. of Facts ¶ 9; Stip. Ex. 4. While "A.B.B.A.'s" sales of "Margaritaville" products averaged $9 million (Stip. of Facts ¶ 9), "A.B.B.A.'s" annual sales were around $50,000,000 (Tr. p. 54). The record shows that sales of "Margaritaville" products constituted less than 7% of "A.B.B.A.'s" total sales in March, 1992, and approximately 11% of "A.B.B.A.'s" total sales in March, 1993. Stip. Ex. 4. These activities were unrelated to "Ponderosa's" unitary business, which had nothing to do with the snack food business immediately prior to, and at the time "Ponderosa" sold its interest in "A.B.B.A.". Stip. Ex. 21, 22, 23. Since "Ponderosa" was not involved in the activities that produced the vast majority of "A.B.B.A.'s" revenues, it would be difficult to characterize "Ponderosa's" relationship with "A.B.B.A.'s" primary income producing activities as an "integral" one.

Given the absence of any relationship between "Ponderosa" and relationship between "Ponderosa" and "A.B.B.A.'s" principal business, the issue presented is whether the record shows that "A.B.B.A.'s" activities as a "Ponderosa" distributor were integral to "Ponderosa's" unitary business. The taxpayer argues that the record does not support such a finding. Taxpayer Brief page 24 ("The capital asset here, "Ponderosa's" interest in "A.B.B.A.", was not integral, *but incidental* to "Ponderosa's" business operations").

In Texaco-Cities Service, *supra*, the Illinois Supreme Court held that income from a capital asset is business income if the asset itself is integral to the taxpayer's regular trade or business operations. Texaco-Cities Service, at page 268, 271, 272, 273, 275. In making its determination whether income was apportionable in this case, the court looked

for guidance to regulations promulgated by the Department which it noted "although not binding upon us … are entitled to substantial deference". Texaco-Cities Service, at 272.

The application of the functional test is addressed in the Department's income tax regulation entitled "Business and non-business income", 86 Ill. Admin. Code § 100.3010. 86 Ill. Admin. Code § 100.3010(d)(5) provides that income from stock is properly classified as business income "where the purpose for acquiring or holding the stock is related or attendant to such trade or business operations." (Emphasis supplied).[6] The example at 86 Ill. Admin. Code § 100.3010(d)(5)(E) of these regulations addresses the status of companies which, like "A.B.B.A.", are engaged in marketing products for an affiliated entity. This example states as follows:

> (d) Items referred to in IITA Section 303 and unspecified items under IITA Section 301(c)(2).
>
> (1) In general … Any item may, in a given case, constitute either business income or non-business income depending on all the facts and circumstances. The following are rules and examples for determining whether particular income is business or non-business income. (The examples used throughout these regulations are illustrative only and do not purport to set forth all pertinent facts.)
>
> ****
>
> (5) Dividends. Dividends are business income where the stock with respect to which the dividends are received, is held or was acquired in the regular course of the person's trade or business operations or where the purpose for acquiring or holding the stock is related or attendant to such trade or business operations…
>
> (E) Example E: A corporation receives dividends from the

[6] While 86 Ill. Admin. Code § 100.3010(d)(5) addresses the classification of dividends as business income or non-business income, the U.S. Supreme Court has stated that the reasoning applicable to classifying dividends is equally applicable to the classification of gains from the sale of stock as business or non-business income. ASARCO Inc. v. Idaho Tax Commission, 458 U.S. 307, 330 (1982). The first clause of 86 Ill. Admin. Code § 100.3010(d)(5) states that income is business income if "the stock with respect to which the dividends are received is held or was acquired in the regular course of the person's trade or business operations … ." This part of the regulation restates the "transactional" test for determining whether income is apportionable, and is not applicable to "Ponderosa's" interest in "A.B.B.A." for the reasons noted above.

> stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the corporation. The dividends are business income.

86 Ill. Admin. Code § 100.3010(d)(1), (5)(E)

The above example indicates that a marketing affiliate that is controlled by a manufacturer would be considered an integral part of the manufacturer's operations. Accordingly, pursuant to this regulation, the income produced from dividends or capital gains attributable to this type of entity would constitute business income. *Id.*

At the time "A.B.B.A." became a distributor of "Ponderosa" products, "Ponderosa" had become a minority investor in the company, holding only 49% of the company's stock. Tr. p. 154; Stip. of Facts ¶¶ 8, 9; Stip. Ex. 6, 17. While the taxpayer held three of the six seats on "A.B.B.A.'s" board of directors, there is no evidence that the taxpayer's board members had any say or influence over "A.B.B.A.'s" corporate policy or day-to-day operations. Tr. pp. 97, 98, 104, 105, 157. As a result of its status, "Ponderosa" was unable to exert management control over "A.B.B.A." or to control the direction the business would take in the future. This lack of control is vividly illustrated by "Ponderosa's" efforts to redirect "A.B.B.A.'s" activities to bring them more in line with "Ponderosa's" long term business objectives. See Stip. Ex. 7, letter from "JS" dated October 13, 1992. These efforts were completely thwarted by "FMS AB", the holder of a majority interest in "A.B.B.A.". *Id*.

The record also shows that "A.B.B.A." did not act as a controlled "agent" of "Ponderosa". "A.B.B.A.'s" management made all decisions regarding marketing strategies, and on the kind and amount of "Ponderosa" products "A.B.B.A." would purchase. Tr. pp. 100, 101. Moreover, the manner in which these products were resold

was completely within "A.B.B.A.'s" discretion. *Id.* Given "Ponderosa's" lack of control over "A.B.B.A.", regulation 86 Ill. Admin. Code § 100.3010(d)(5)(E), which deals with a marketing agent under the control of a manufacturer, does not apply to "Ponderosa's" relationship with "A.B.B.A." in this case.

The evidence also shows that "A.B.B.A.'s" contribution to "Ponderosa's" gross revenues was *de minimis*. The record shows that between 1990 and 1993, less than ½ of 1% of "Ponderosa's" gross revenues reported on "Ponderosa's" published financial statements were attributable to its relationship with "A.B.B.A.". Tr. pp. 114, 115, 116, 117, 118, 119, 158, 159, 160; Stip. ¶ ¶ 14, 15. Moreover, nothing in the transactions between these two companies indicates that either "Ponderosa" or "A.B.B.A." gained any special economic advantage by virtue of "A.B.B.A.'s" status as a "Ponderosa" investment. The record does not indicate that there were any guarantees of purchases or sales, or that "A.B.B.A." was given any special price breaks. Tr. pp. 108, 109, 110; Stip. of Facts ¶ 19; Stip. Ex. 17. "Ponderosa", as a minority investor, was in no position to impose such arrangements on "A.B.B.A.'s" management, since any effort to do so would have been disadvantageous to the income earned from "A.B.B.A." by "FMS AB", "A.B.B.A.'s" majority stockholder.

The record supports the taxpayer's argument that "A.B.B.A.'s" contribution to "Ponderosa's" unitary business was not integral or essential to "Ponderosa's" unitary business operations. The record indicates that many of "Ponderosa's" distributors were not affiliated with "Ponderosa" in any way and yet purchased "Ponderosa" products on the same terms as "A.B.B.A.". Moreover, "A.B.B.A." continued to act as a "Ponderosa" distributor after "Ponderosa" completely divested itself of its "A.B.B.A." stock. As

pointed out by the taxpayer "the terms of the relationship remained the same even after "Ponderosa" no longer had any investment in ["A.B.B.A."]". Taxpayer Brief p. 25.

In sum, the record shows that "A.B.B.A." was, in essence, a "Ponderosa" wholesale "customer". Tr. p.163. ("[T]hey were a customer of ours"). "A.B.B.A.'s" management decided what quantity of merchandise it would purchase and how and when to sell this inventory. Tr. pp. 100, 101. Moreover, "A.B.B.A." received no special pricing or other benefits as a consequence of its status as a "Ponderosa" investment. Tr. pp. 108, 109, 110. After "Ponderosa" sold its investment in "A.B.B.A.", "A.B.B.A.'s" function as a "Ponderosa" distributor did not change in any way. Stip. of Facts ¶ 19. This evidence indicates that "Ponderosa's" investment in "A.B.B.A." was immaterial and unrelated to "A.B.B.A.'s" "distributor" relationship to "Ponderosa". Applying the criteria enumerated in 86 Ill. Admin. Code § 100.3010(d)(5), the record does not support a finding that "Ponderosa's" purpose for holding stock in "A.B.B.A." was "related or attendant to" "Ponderosa's" unitary business operations.

The Department contends that the functional test is met in this case because the record shows a connection between "Ponderosa's" ownership of "A.B.B.A." and "Ponderosa's" desire to create a broader worldwide market for its "Margaritaville" brand of products and increase the sale of "Ponderosa" food products. Dept. Brief pp. 12, 13, 14, 15. This goal was to be achieved through the acquisition of companies with existing foreign operations and marketing expertise. Tr. pp. 25, 33, 42. The Department argues that "A.B.B.A.'s" existing market presence and infrastructure in Sweden made it part of this strategy. Dept. Brief p. 14. In support of these contentions, the Department points out that "A.B.B.A.'s" sales were taken into account in evaluating whether "Ponderosa's"

international group growth objectives had been met, and that "A.B.B.A." was an original member of "Ponderosa's" international group. Dept. Brief pp. 13, 18, 19. In sum, the gravamen of the Department's claim is that "Ponderosa's" books and records treated "A.B.B.A." as a component of "Ponderosa's" international group and "Ponderosa's" internal accounting factored "A.B.B.A.'s" growth into the growth and development of "Ponderosa's" international operations.

There is no question that "Ponderosa's" investment in "A.B.B.A." was included in "Ponderosa's" international group, and evaluated as one of that group's assets for internal accounting purposes. However, from a tax standpoint, there is a major difference between "A.B.B.A." and other companies in "Ponderosa's" international group. [7] Hence, the fact that "A.B.B.A." may have been evaluated in the same manner as other affiliates in this group does not prove that "Ponderosa's" income from "A.B.B.A." was apportionable.

From a tax standpoint, there is a crucial distinction between "A.B.B.A." and most of "Ponderosa's" other foreign assets because unlike "A.B.B.A.", these entities were "Ponderosa" subsidiaries. Moreover, the parent of most of these subsidiaries, the "Wombat, Inc.", was included in "Ponderosa's" unitary business group. Stip. Ex. 19, 20. Income derived from unitary operations is clearly apportionable income under Illinois law. 86 Ill. Admin. Code § 100.3010(b),(c); Caterpillar Tractor Co. v. Lenckos, 84 Ill. 2d

[7] The companies in "Ponderosa's" international group were the "Wombat, Inc." and its subsidiaries in England, Australia, Venezuela, Mexico and Canada, "A.B.B.A." and "P", a Canadian subsidiary engaged in the manufacture of Italian foods. Tr. pp. 26, 27, 28, 30, 31, 32, 33, 166, 167. "Ponderosa" also briefly owned an interest in a Costa Rican joint venture, which it acquired in 1981, and sold in the early 1980s. Tr. pp. 26, 27, 111, 112. With the exception of "A.B.B.A.", the international group consisted of "Ponderosa" subsidiaries during the tax periods in controversy. "Wombat, Inc.", the parent of all but one of these subsidiaires, was a member of "Ponderosa's" unitary business group. Stip. Ex. 19, 20.

102 (1981); Citizens Utilities of Illinois v. Department of Revenue, 111 Ill. 2d 32 (1986); Filtertek, Inc. v. Department of Revenue, 186 Ill. App. 3d 208 (2nd Dist. 1989); Borden, Inc. v. Department of Revenue, 295 Ill. App. 3d 1001 (1st Dist. 1998); A.B. Dick Company v. McGraw, 287 Ill. App. 3d 230 (4th Dist. 1997). Unlike "Wombat, Inc.", the parent company of most of "Ponderosa's" international group, and "Ponderosa's" other subsidiaries, "A.B.B.A." could not have qualified for inclusion in "Ponderosa's" unitary business group under Illinois law because "Ponderosa" never owned a majority of "A.B.B.A.'s" stock. Hercules, at 425; 35 **ILCS** 5/1501(a)(27). Hence, Illinois law allowing income derived from a unitary business operation to be apportioned, while applicable to Underwood and other "Ponderosa" subsidiaries, could not be applied to apportion the income of "A.B.B.A." because "Ponderosa" and "A.B.B.A." were not unitary. *Id.*

Moreover, the manner in which investments and assets are classified and accounted for in a company's books and records does not determine taxability. Thor Power Tool Co. v. Commissioner of Internal Revenue, 439 U.S. 522, 541 (1979) ("[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same" [quoting Frank Lyon Co. v. United States, 435 U.S. 561, 577 [1978]); Exxon Corp. at 221 ("As this Court has on several occasions recognized, a company's internal accounting techniques are not binding on a State for tax purposes"). If the objective characteristics of the business relationships between "Ponderosa" and "A.B.B.A." fail to establish a basis for the classification of the

gain at issue as business income, the taxpayer cannot be subject to tax regardless of how it chooses to characterize its investment in "A.B.B.A." for internal accounting purposes.[8]

The Department also argues that "Ponderosa's" gain on its sale of its minority interest in "A.B.B.A." constituted business income under the functional test because the record shows that this stock was sold in order to generate "more resources to apply to ["Ponderosa's"] other businesses". Dept. Brief p. 12. However, as pointed out by the U.S. Supreme Court in ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982), one must assume that all corporate activities will be funded with the corporation's available capital; all expenditures of a company's capital "in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business' … " ASARCO, at 326. The court goes on to conclude that this "corporate purpose" test for determining when income can be classified as apportionable, "when pressed to its logical limit … becomes no limitation at all" on the state's right to apportion income. *Id*.

The U.S. Supreme Court again rejected the "corporate purpose" test in Allied-Signal. Allied-Signal, at 788, 789. See also Hercules, at pp. 232, 233. The Department's illustrations in 86 Ill. Admin. Code § 100.3010(d)(5) distinguishing between business and non-business income from stock investments comport with the U.S. Supreme Court's pronouncements. None of these illustrations indicate that an integral connection to the taxpayer's operations needed to support a finding of business income, can be supplied

[8] "Ponderosa" accounted for its 49 percent interest in "A.B.B.A." using the "equity method". Tr. pp. 159, 160. Consequently, "Ponderosa" included 49 percent of "A.B.B.A.'s" net income as "Ponderosa's" net income. Tr. pp. 160, 161. "Ponderosa" consistently accounted for all of its 20 percent to 50 percent owned affiliates using this method (Stip. Ex. 21, 22). Its use of the "equity method" to account for its interest in "A.B.B.A." was based on the percentage of "A.B.B.A.'s" stock "Ponderosa" held rather than on the presence or absence of any operational relationship with this company. Tr. pp. 160, 161, 162. See also "Equity Method of Accounting for Investments in Common Stock," Opinion of Accounting Principles Board No. 18 (New York: AICPA, 1971). Accordingly, the use of the equity method is not indicative of any operational relationship between "Ponderosa" and its investment in "A.B.B.A.".

merely by a showing that the proceeds from the sale of stock were used in the taxpayer's ongoing business activities.

In sum, after considering all of the facts revealed in the record, for the reasons noted above, I conclude that the taxpayer has rebutted the Department's prima facie determination that the income at issue here should have been reported as business income. The record clearly shows that from approximately 1967 on, "Ponderosa's" unitary business was unrelated to "A.B.B.A.'s" snack food business, "A.B.B.A.'s" principal business activity. "A.B.B.A.'s" "Ponderosa" product distribution activity was of *de minimis* significance to "Ponderosa's" unitary business, and "Ponderosa's" relationship with "A.B.B.A.'s" distribution activities was essentially the same as its relationship with non-affiliated distributors. This evidence rebuts the Department's prima facie case. It fully supports the taxpayer's claim that "Ponderosa's" equity interest in "A.B.B.A." was not integrally related to its unitary business at the time "Ponderosa's" stock in "A.B.B.A." was sold. Consequently, I conclude that "Ponderosa's" gain from the sale of "A.B.B.A." did not constitute business income under the functional test.

Due Process and Commerce Clause Issue

The conclusion that the gain on the taxpayer's sale of 49% of "A.B.B.A.'s" stock was non-business income is also dictated by constitutional limitations on non-domiciliary states' taxing authority. As a general principle, a state may not tax values earned outside its borders. ASARCO Inc., *supra*. In order to do so, the record must show "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." Allied-Signal at 777, quoting Miller Brothers Co. v. Maryland, 347 U.S. 340, 344, 345 (1954); See also Hercules at 335.

The taxpayer vigorously contends that a connection between the taxpayer's business activities conducted in Illinois and the activities conducted by "A.B.B.A." must be shown in order to apportion the "A.B.B.A." gain. Taxpayer Reply Brief p. 1 (""Ponderosa's" main argument is that, under the Supreme Court's apportionment cases, Illinois cannot tax "Ponderosa" on the gain from the sale of its interest in "A.B.B.A." because the evidence shows that there was no nexus between "Ponderosa's" investment in the Swedish distributor and "Ponderosa's" own activities in this State"). "Ponderosa" contends that "Ponderosa's" activities in Illinois only related to the taxpayer's refrigerated salad and mixed spices businesses and that "Ponderosa's" stake in "A.B.B.A." was unrelated to these activities. *Id*. "Ponderosa" urges a ruling that the gain from "A.B.B.A." cannot be apportioned because "A.B.B.A.'s" activities were separate and distinct from "Ponderosa's" Illinois operations.

In Allied-Signal, the Supreme Court notes the "fundamental requirement of both the Due Process and Commerce Clauses that there be 'some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.' " Allied-Signal, at 777. This requirement arises from the necessity that the exercise of a state's taxing power over a taxpayer or its activities be justified by the "protection, opportunities and benefits" the state confers upon the taxpayer or its activities. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940). Accordingly, in the absence of a "definite link" or "minimum connection" with the taxpayer's activities, the state has not "given anything for which it can ask return." *Id*.

The Supreme Court has expressly rejected, however, a "rigid, formalistic definition of minimum connection". Allied-Signal, at 778. Moreover, the Supreme

Court has not required a showing of a connection between the taxpayer's business activities conducted in the taxing state and the asset generating apportionable income. Thus in Mobil Oil Corp. v. Commissioner of Vermont, 445 U.S. 425 (1980) the court states:

> In support of the contention that dividend income ought to be excluded from apportionment, Mobil has attempted to characterize its ownership and management of subsidiaries and affiliates as a business distinct from its sale of petroleum products in this country. Various *amici* also have suggested that the division between the parent and subsidiary should be treated as a break in the scope of unitary business, and that the receipt of dividends is a discrete "taxable event" bearing no relation to Vermont. … At the outset, we reject the suggestion that anything is to be gained by characterizing receipt of the dividends as a separate "taxable event." In *Wisconsin v. J.C. Penney Co., supra,* the Court observed that "tags" of this kind "are not instruments of adjudication but statements of result," and that they add little to analysis. 311 U.S. at 444, 61 S. Ct., at 250. Mobil's business entails numerous "taxable events" that occur outside of Vermont. That fact alone does not prevent the State from including income earned from those events in the pre-apportionment tax base."
> Mobil Oil at 440.

Rather, the Supreme Court has indicated that a significant operational connection between an income-producing asset outside of the taxing state and the taxpayer's unitary business as a whole is sufficient to meet the "minimum connection" requirement. Allied-Signal, at pp. 787, 788. This relationship must be more than a *de minimis* one to support a finding that apportionment is constitutionally permitted. Allied-Signal, *supra*.

Accordingly, the constitutional issue presented in this case is whether the taxpayer has produced sufficient evidence to show the absence of a minimum connection between "Ponderosa's" unitary business operations, which are partly conducted in Illinois, and "A.B.B.A.". As pointed out above, "Ponderosa" must show by "clear and cogent" evidence that the requisite connection between its unitary business and

"A.B.B.A." does not exist. Container Corp. of America, *supra;* Allied-Signal, *supra*; Moorman Manufacturing Co., *supra*; Butler Brothers, *supra*; Exxon Corp., *supra*.

The existence of a unitary relationship between a taxpayer realizing a capital gain and the entity whose stock was sold is one means of meeting constitutional requirements for taxing income by apportionment. Allied-Signal, at 785; Mobil Oil Corp. at 439 ("[T]he linchpin of apportionability in the field of state income taxation is the unitary business principle.") In this case, the taxpayer argues that the Department cannot meet the constitutional prerequisites required to apportion "Ponderosa's" gain from the sale of "A.B.B.A." by showing that "Ponderosa" and "A.B.B.A." were engaged in a unitary business at the time "Ponderosa" sold its 49% interest in "A.B.B.A.". Taxpayer Brief pp. 9, 10, 11, 12, 13. The Illinois Income Tax Act prescribes the criteria to be applied in determining whether a unitary business exists at 35 **ILCS** 5/1501(a)(27), which provides in pertinent part as follows:

> The term "unitary business group" means a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other… Common ownership in the case of corporations is the direct or indirect control or ownership of more than 50% of the outstanding voting stock of the persons carrying on unitary business activity.
> 35 **ILCS** 5/1501(a)(27)

The U.S. Supreme Court has also prescribed criteria for making this determination, stating that indicia of a unitary business are functional integration, centralization of management and economies of scale. Allied-Signal, at 789. Functional integration can be established by showing that there are transfers of products between companies in the same or similar businesses. Exxon Corp., *supra*. Economies of scale have been found to exist where two enterprises can combine their resources to produce a

less expensive product. Citizens Utilities, *supra*. Centralization of management is found where a single cadre of officers and directors control the operations of a related group of companies. *Id.* Evidence of centralization of management is found where affiliated corporations share the same officers and have interlocking boards of directors. *Id.* Hormel Foods Corp. and Jennie-O-Food, Inc. v. Zehnder, 316 Ill. App. 3d 1200, 1210 (1st Dist. 2000).[9] The taxpayer contends that neither the test for determining a unitary business set forth in section 1501(a)(27) of the IITA, 35 **ILCS**5/1501(a)(27), nor the test set forth in Allied-Signal has been met in this case.

The record supports a finding that the taxpayer and "A.B.B.A." were not engaged in a unitary business under the standard set forth in section 1501(a)(27) of the IITA, 35 **ILCS** 5/1501(a)(27), at the time the taxpayer sold its minority interest in "A.B.B.A.". The record shows that the taxpayer held a minority interest at the time of this sale, and that the taxpayer at no time held more than 50% of the stock of "A.B.B.A.". Tr. pp. 171, 172, 173; Stip. of Facts ¶ ¶ 6, 9, 17, 18. As noted in Hercules, *supra*, "Illinois law requires that in order for a subsidiary to be a member of a unitary business group with its parent, the parent corporation must control or own more than 50% of the stock of the subsidiary". *Id* at 425.

With respect to centralization of management, the record indicates that "A.B.B.A." officers, under the direction of "FMS AB", ran the company independently of "Ponderosa". Tr. pp. 95, 96, 97, 98. "Ponderosa's" management had no authority over "A.B.B.A.'s" day to day operations, policies or procedures. Tr. pp. 97, 98. The

[9] The Illinois appellate court has rejected the notion that functional integration is a separate concept from centralized management and held that "whenever there is functional integration of operations there is also strong centralized management and vice versa." A.B. Dick Co. v. McGraw, 287 Ill. App. 3d 230, 233 (4th Dist. 1997).

record also indicates that "A.B.B.A.'s" management did not report to "Ponderosa's" management. Tr. pp. 68, 98. This evidence, which the Department did not rebut or even contest, is indicative of a lack of centralization of management between "Ponderosa" and "A.B.B.A." for purposes of applying the Allied-Signal test for determining whether a unitary business exists.

The record shows that "Ponderosa" did have three directors on the "A.B.B.A." board. Tr. pp. 55, 74, 96. [10] However, the Supreme Court has held that having some common directors is not enough to establish centralization of management. In Allied-Signal, the court concluded that there was no centralization of management even though Allied-Signal's chief executive officer and one of its directors had seats on the board of a company it sold. Allied Signal at 775.

The record also supports a finding that "Ponderosa" and "A.B.B.A." were not functionally integrated. There is no evidence that these companies sold raw materials or intermediate products to each other. Moreover, "Ponderosa's" sales of "Margaritaville" products constituted a *de minimis* portion of "Ponderosa's" overall sales. Stip. ¶ ¶ 14, 15.

With respect to economies of scale, the record shows that "A.B.B.A." and "Ponderosa" had entirely separate manufacturing and distribution facilities. "Ponderosa" had no manufacturing or distribution facilities in Sweden, while all of "A.B.B.A.'s" facilities were in that country. Tr. pp. 80, 81, 99, 101, 102, 153; Stip. Ex. 23. Mr. "Udwin" testified that each company had its own employees and that, with the exception

[10] The Department argues that the taxpayer had three seats on "A.B.B.A.'s" six member board, and therefore effectively controlled "A.B.B.A." through its ability to veto any corporate actions it did not favor. Dept. Brief pp. 21, 22. However, this veto power, which was never exercised (Tr. pp. 96, 97) at best constituted the potential to control "A.B.B.A.". The U.S. Supreme Court has held that mere potential control is not enough to justify apportionment if the affiliated income producing entity comprises a discrete business operation. F.W. Woolworth Co. v. Taxation and Revenue Department of the State of New

of auditing and accounting related to "Ponderosa's" financial reports, "Ponderosa" provided no public relations, medical, insurance, legal, tax, regulatory, billing or other services to "A.B.B.A.". Tr. pp. 107, 108.

In sum, I find clear and cogent evidence in the record to support the taxpayer's claim that it was not engaged in a unitary business with "Ponderosa". Since "Ponderosa" never owned a majority of "A.B.B.A.'s" stock, "A.B.B.A." was precluded from being included in "Ponderosa's" unitary business group by Illinois law. 35 **ILCS** 5/1501(a)(27); Hercules, at 425. Moreover, the record does not indicate the existence of functional integration, centralization of management or economies of scale, which the U.S. Supreme Court deems essential to a finding that a unitary business exists. Allied-Signal, at 782, 783. Accordingly, I find that "Ponderosa" and "A.B.B.A." were not engaged in a unitary business at the time of the sale of "A.B.B.A.'s" stock in 1993.

While a showing of a unitary relationship between "Ponderosa" and "A.B.B.A." is one way of meeting the constitutional requirements for Illinois to tax "Ponderosa's" capital gain by apportionment, it is not the only means. Allied-Signal, at 787. If the evidence shows that the "A.B.B.A." stock "Ponderosa" held served an operational rather than an investment function, then the income can properly be apportioned and taxed by Illinois, even if "Ponderosa" and "A.B.B.A." were not engaged in a unitary business. *Id.*

In Allied-Signal the Supreme Court explained that a stock investment would be an operational asset if it "amounted to a short-term investment of working capital analogous to a bank account or certificate of deposit". Allied-Signal, at 790. However, the record in this case indicates that the taxpayer's interest in "A.B.B.A.'s" stock did not meet this

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Mexico, 458 U.S. 354, 362 (1982); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992).

criteria because it was not a short-term investment. The taxpayer's investment in "A.B.B.A." dated from 1965 when this joint venture was organized. Stip. of Facts ¶ 5; Stip. Ex. 17. Thus, "Ponderosa's" interest in "A.B.B.A." was clearly a long term investment. Moreover, "Ponderosa" funded its unitary business with cash flow from these operations, and did not rely on cash it received from "A.B.B.A." for this purpose. Tr. pp. 169, 170.

The conclusion that "Ponderosa's" investment in "A.B.B.A." was not analogous to a short term CD or bank account is supported by the reasoning in Hercules, *supra*. The issue in this case was whether the gains Hercules recognized on the sale of a minority interest in the stock of a supplier company constituted business income. The appellate court ruled that this gain could not properly be characterized as apportionable business income under the U.S. Supreme Court's ruling in Allied-Signal. In reaching this conclusion, the court addressed the issue of whether taxpayer's investment was analogous to a short term investment of working capital in a CD or bank account. The court found that Hercules' investment in the minority stock of its supplier was not analogous to a short term banking investment. Hercules, at 430. It found that there was no evidence that Hercules used its investment in its supplier as a repository for, or as a ready source of working capital. *Id.* The record in this case is also devoid of any such evidence.

In Allied-Signal, the court indicated that an operational function can also be found where stock of a company is acquired to assure a supply or raw materials for a manufacturing concern or as a hedge against price inflation. Allied-Signal, at 788. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955) (futures transactions found to be an integral part of taxpayer's business where they were designed to protect its

manufacturing operations against a price increase in its principal raw material and assure a ready supply). However, the record does not indicate that "Ponderosa's" investment in "A.B.B.A." existed to provide the taxpayer with a supply of raw materials. There is no evidence in the record that "Ponderosa" purchased any "A.B.B.A." products. Moreover, the record contains no evidence that any ingredients used in "Ponderosa" products were from "A.B.B.A.".

In sum, the record in this case supports a finding that "Ponderosa" and "A.B.B.A." were not engaged in a unitary business. Moreover, the record indicates that "Ponderosa's" minority interest in "A.B.B.A." was not held for an operational purpose. Accordingly, I conclude that the taxpayer has produced clear and cogent evidence showing that the Department has not met the constitutional requirements for taxing "Ponderosa's" gain on its sale of "A.B.B.A." stock by apportionment.

The Department contends that "A.B.B.A." was integrally related to "Ponderosa's" unitary operations and was an asset that served an operational function in that business rather than merely an investment function. Dept. Brief pp. 15, 16, 17, 18, 19. In support of this contention, it points to evidence that "A.B.B.A.'s" growth was used to measure "Ponderosa's" international sales growth, and its sales were considered in determining whether "Ponderosa's" internal sales objectives were being achieved. Dept. Brief pp. 18, 19. It maintains that the inclusion of "A.B.B.A." in "Ponderosa's" international group, and "A.B.B.A.'s" sales in the taxpayer's overall sales for internal purposes shows a clear connection between the taxpayer's purchase and ownership of "A.B.B.A." stock and "Ponderosa's" efforts to create a broader worldwide market for "Ponderosa's" domestically produced products. However, the Department's brief does not indicate what

specific steps were undertaken to assist "A.B.B.A." in accomplishing "Ponderosa's" objectives other than encouraging "A.B.B.A." to increase its rate of growth and recording this growth as a part of the growth in "Ponderosa's" international business. The record does not indicate that "Ponderosa" increased its capital investment in "A.B.B.A." by transferring assets or cash to this company, or by sharing its marketing or other expertise. The absence of such evidence cast doubt on the Department's position.

Moreover, in evaluating the relationship between "A.B.B.A." and "Ponderosa", one cannot rely solely upon the classification of "A.B.B.A." for internal management purposes. The substantiality of this relationship can better be evaluated by looking at "A.B.B.A.'s" importance to "Ponderosa's" unitary business. The record shows that "A.B.B.A." accounted for less than ½ of 1% of "Ponderosa's" overall sales. Stip. of Facts ¶ ¶ 14, 15. Furthermore, "A.B.B.A." derived its income principally from its snack food business, a business that was unrelated to "Ponderosa's" unitary business, since "Ponderosa" and its subsidiaries did not manufacture or distribute snack foods during and immediately preceding the audit period at issue. Stip. Ex. 21, 22, 23. This evidence supports the taxpayer's claim that "A.B.B.A.'s" primary importance to "Ponderosa" was as an investment.

The gravamen of the Department's constitutional claim is that, given evidence of an important relationship between "A.B.B.A." and "Ponderosa's" international business, the taxpayer failed to show by clear and cogent evidence that "A.B.B.A." was unrelated to "Ponderosa's" unitary business operations. However, in Hercules, the appellate court made it abundantly clear that the existence of an operational asset cannot be established merely by showing an important relationship between that asset and the taxpayer's

operations. Were such a showing sufficient, the Department would have easily prevailed in Hercules because the record in that case was replete with numerous important connections between the business operations of Himont and Hercules. In addition to supplying numerous services to Himont, Hercules purchased from 80% to 85% of the polypropylene it used in its business from this company. Hercules at 422.

Under the tests for determining whether income can be apportioned enumerated in Hercules, a showing of some important operational connection alone is not sufficient to establish apportionability. Rather this case says that a taxpayer seeking non-business income treatment of a capital gain will prevail if it can show that: 1) it did not have a unitary relationship with the enterprise that was sold; and 2) that its non-unitary relationship with this entity did not possess attributes typical of centralized management. Thus, under Hercules, a critical factor in deciding whether an asset is operational in nature is whether the taxpayer exercised management control over the enterprise prior to selling it. Hercules at 430. The court, in this case, found that the entity being sold, Himont was operated as a 'stand alone' corporation. *Id.* It highlighted the fact that Hercules never owned a majority of the stock of Himont, never exercised management control and that transactions between these entities were at arms length. *Id.* Based on this finding, its concluded that there was no centralized management or functional integration between Hercules and Himont. [11]

[11] The Department notes that Justice O'Connor, in her dissent in Allied-Signal v. Director, Division of Taxation, 504 U.S. 768 (1992), states that "active operational control of the investment income payor by the taxpayer is certainly not required" for a state to apportion such investment income. Dept. Brief p. 21, citing Allied Signal at 791. The Department's reliance on Justice O'Connor's dissenting opinion in Allied Signal is misplaced. Justice O'Connor agreed with the majority in this case that a unitary relationship need not exist between the taxpayer and the payor of dividends and/ or capital gains for those earnings to be apportionable. However, she clearly parted company with the majority in its application of tests to determine apportionability where a unitary relationship does not exist. The standard for determining

The record in this case shows that the structural relationship between "Ponderosa" and "A.B.B.A." was identical, in many respects, to the relationship between Hercules and its joint venture investment. Like "Ponderosa", Hercules had enlisted a foreign partner to form a joint venture called Himont. Hercules at 421, 422. Like "Ponderosa", Hercules initially owned 50% of the stock in Himont. *Id.* Moreover, like "Ponderosa", Hercules had the right to appoint three directors to Himont's six-member board. *Id*. Like "Ponderosa", Hercules subsequently became a minority investor in Himont. *Id*. Most importantly, like "A.B.B.A.", Himont was operated as a "stand alone corporation". Hercules at 430. The record shows that "Ponderosa" had no control over "A.B.B.A.'s" day to day operations, policies or procedures, and was not involved in the management of "A.B.B.A.". Tr. pp. 98, 157. The court emphasizes the importance of this factor in determining whether an investment in an affiliate serves an operational function, stating as follows:

> The Department does not suggest nor is there any evidence in the record that this investment provided a supply of working capital analogous to a bank account or certificate of deposit. The Department, however, relies upon Hercules' authority to appoint officers and members of Himont's board of directors, the administrative services it provided Himont, and its purchase of polypropylene for purposes of demonstrating an operational function. As noted above, Hercules did not assert any management control over Himont. Hercules never owned a majority of stock in Himont, its officers did not oversee the day-to-day operations of Himont, and all of its employees that went to work for Himont permanently resigned their positions with Hercules. Himont employed its own officers and management board. From its inception, Himont existed as an independent, stand alone corporation.
> *Id* at 430.

Like the record in Hercules, the record in this case is similarly devoid of any evidence of centralized management between "A.B.B.A." and "Ponderosa". Consequently, I find

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whether an asset is an operational asset upon which the Department relies was advanced in a dissent, and

that the record in this case supports the same conclusion the appellate court reached in Hercules.

The Department seeks to distinguish Hercules by emphasizing that in Hercules the court found that the taxpayer formed Himont to divest itself from an operational relationship with its former polypropylene business. Taxpayer Brief p. 20. Conversely, it argues, "A.B.B.A." functioned to further "Ponderosa's" ongoing business enterprise as a result of its status as a "Ponderosa" distributor. Department Brief p. 20. While the Department correctly points out that the facts in Hercules and the facts in the instant case are not identical, the distinction between these cases noted by the Department does not support a finding that "A.B.B.A." was an operational asset of "Ponderosa".

The record indicates that, while "A.B.B.A." made purchases from "Ponderosa" in its capacity as a "Ponderosa" distributor, these purchases were at arms length prices, and constituted a *de minimis* amount of "Ponderosa's" total sales, producing less than ½ of 1 percent of "Ponderosa's" total revenues between 1990 and 1993. Stip. ¶ ¶ 14, 15. In Allied-Signal the Supreme Court indicated that *de minimis* intercompany sales of this nature between a taxpayer and its affiliate, Asarco, were not enough to support a finding that Asarco constituted an operational asset. The court ruled that the taxpayer's interest in its affiliate constituted an investment in spite of a showing that "(t)here were certain sales of product in the ordinary course of business by Asarco subsidiaries to [Allied-Signal]". Allied-Signal, at 775. The court's conclusion was based on its finding that these sales were at arms length and "were minute compared to Asarco's total sales." *Id*.

In sum, the record in this case shows that the vast majority of "A.B.B.A.'s" revenues were produced by its snack food business conducted exclusively in Sweden.

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dissents are clearly not the law.

This business was unrelated to "Ponderosa's" unitary business during, and immediately before the tax periods in controversy. Hence, "A.B.B.A." was primarily engaged in a business that had nothing to do with "Ponderosa's" unitary business when "Ponderosa" sold its interest in "A.B.B.A." in 1993. While "A.B.B.A." was also a distributor of "Ponderosa" products, the revenues from this business were *de minimis* and insufficient to support a finding that "A.B.B.A." constituted an operational asset under Allied-Signal.

Conclusion

As noted above, the sole issue before this tribunal is whether the Department properly assessed tax on "Ponderosa's" gain from the sale of "A.B.B.A." stock during the tax year ending 6/30/93. Accordingly, the taxpayer has not contested the portion of the NOD covering the tax years ending 6/30/92 and 6/30/94

WHEREFORE, for the reasons stated above, it is my recommendation that the NOD be modified to cancel the assessment on the taxpayer's gain from the sale of "A.B.B.A." stock during the tax year ending 6/30/93 and related penalty and, as modified, be made final.

Respectfully submitted,

Ted Sherrod
Administrative Law Judge